

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of
Shell Oil Co. :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law for :
the Years 1966-1967, 1971-1977.

State of New York }

ss.:

County of Albany }

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 5th day of October, 1984, he served the within notice of Decision by certified mail upon Shell Oil Co. the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Shell Oil Co.
1 Shell Plaza, P.O. Box 2463
Houston, TX 77001

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
5th day of October, 1984.

David Parchuck

James A. [Signature]
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

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David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 5th day of October, 1984, he served the within notice of Decision by certified mail upon J.L. Kennedy the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

J.L. Kennedy
c/o Shell Oil Co., 1 Shell Plaza, P.O. Box 2463
Houston, TX 77001

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
5th day of October, 1984.

David Parchuck

James A. Haynes
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

October 5, 1984

Shell Oil Co.
1 Shell Plaza, P.O. Box 2463
Houston, TX 77001

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
J.L. Kennedy
c/o Shell Oil Co., 1 Shell Plaza, P.O. Box 2463
Houston, TX 77001
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
	:	
of	:	
	:	
SHELL OIL COMPANY	:	DECISION
	:	
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Years 1966,	:	
1967 and 1971 through 1977.	:	

Petitioner, Shell Oil Company, 1 Shell Plaza, P.O. Box 2463, Houston, Texas 77001, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1966, 1967 and 1971 through 1977 (File Nos. 17432, 25612 and 26515).

A formal hearing was held before Frank W. Barrie, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on January 20, 1983 at 1:25 P.M., with all briefs to be submitted by June 24, 1983. Petitioner appeared by J. L. Kennedy, Esq. (Elizabeth C. Burton, Esq., of counsel). The Audit Division appeared by Paul B. Coburn, Esq. (Kevin A. Cahill, Esq., of counsel). In addition, on January 20, 1983, petitioner by J. L. Kennedy, Esq. (Elizabeth C. Burton, Esq., of counsel), and the Audit Division, by Paul B. Coburn, Esq. (Kevin A. Cahill, Esq., of counsel), executed a stipulation which is incorporated into and made a part of this decision.

ISSUE

Whether the Audit Division, for purposes of determining the property factor of petitioner's business allocation percentage, properly valued petitioner's oil and gas leases by utilizing the net book value method.

FINDINGS OF FACT

1. Petitioner, Shell Oil Company (hereinafter "Shell Oil"), is a Delaware corporation with approximately 35,000 employees. It has business operations in all fifty states and the District of Columbia. Its principal business is the exploration for, and development, production, purchase, transportation and marketing of crude oil and natural gas, and the purchase, manufacture, transportation and marketing of oil and chemical products.

Within New York, Shell Oil's principal business consists of marketing oil and chemical products. It maintains retail district offices in Syracuse, Babylon and New Hyde Park. Petitioner's exploration, manufacturing and refining operations are located outside New York.

2. The Audit Division issued six notices of deficiency against petitioner as follows:

<u>DATE OF NOTICE OF DEFICIENCY</u>	<u>TAX PERIOD AT ISSUE¹</u>	<u>AMOUNT ALLEGED DUE</u>
March 15, 1976	Ended December 31, 1972	\$123,010.63 plus interest
March 15, 1976	Ended December 31, 1973	\$119,493.81 plus interest
August 28, 1978	Ended December 31, 1974	\$169,862.36 plus interest
April 27, 1979	Ended December 31, 1975	\$249,532.48 plus interest
April 27, 1979	Ended December 31, 1976	\$152,424.00 plus interest
April 27, 1979	Ended December 31, 1977	\$196,912.16 plus interest

Against the alleged corporation franchise tax deficiency for the period ended December 31, 1972, the Audit Division credited petitioner with overpayments of such tax for the periods ended December 31, 1967 and December 31, 1971² in the

¹ The 1966 and 1967 years are no longer at issue.

² Petitioner would not be entitled to the refund for 1971 if its primary position is sustained. According to its petition for the 1971 tax year, the 1971 tax would be increased by approximately \$17,745.00 if the petitioner's primary position is adopted because tax would be payable on capital rather than on entire net income. However, if the petitioner's alternative position is adopted, according to Shell Oil, an additional refund would be due for 1971 in the approximate amount of \$18,730.00 plus applicable interest.

amounts of \$171.80 and \$22,318.16, respectively. Attached to each of the notices of deficiency was a statement of audit adjustment which explained that the alleged deficiency of corporation franchise tax was based on the results of a recent field audit report.

3. Petitioner timely filed a Form CT-3, New York State Corporation Franchise Tax Report, for each of the years at issue and remitted corporate franchise taxes of \$302,001.00, \$323,021.00, \$690,417.00, \$1,345,524.00, \$2,204,126.00, \$2,864,574.00 and \$2,656,163.00 for 1971, 1972, 1973, 1974, 1975, 1976 and 1977, respectively.

4. For purposes of this proceeding, petitioner is contesting only the portion of the deficiencies described in Finding of Fact "2", supra, which resulted from the Audit Division's recalculation of petitioner's business allocation percentage on the basis that only the petitioner's net book value for oil and gas leases should be included in the denominator of Shell Oil's property factor. Since the leases are all located outside New York, petitioner's corporation franchise tax liability is increased by the Audit Division's devaluation of such leases.

5. The parties have defined three possible methods for valuing Shell Oil's oil and gas leases:

- (1) the fair market value method,
- (2) the net book value method, and
- (3) the capitalization of royalties as rents method.

The fair market value method, which may also be described as a discounted cash flow method, was utilized by Shell Oil in valuing its oil and gas leases

on the tax returns which it filed for the years at issue.³ Shell Oil's engineers based such value determinations by estimating the proved reserves, projecting future values of both oil and gas prices and operating costs, projecting the future production rates, estimating inflation and then equating back these future amounts of income to a present value.⁴

The Audit Division used the net book value method to value petitioner's oil and gas leases and included only the gross amount of the base acquisition costs less write-offs associated with such leases.

The capitalization of royalties as rent method is an alternative proposed by Shell Oil to the fair market value method of valuation. This proposed alternative would value the subject oil and gas leases by multiplying Shell Oil's annual royalty expense by eight.

6. Shell Oil acquires rights to oil and gas properties both by purchase⁵ and by lease. The typical lease under which Shell Oil acquires the right to use oil and gas properties obligates Shell Oil to pay the lessor three types of

³ The values used by Shell Oil on its returns as filed were developed generally as follows:

- a. Beginning point - Net book value of all Shell Oil Company's fixed assets, land and inventories from balance sheets, plus capitalized rentals.
- b. Subtract - Net book values of exploration and production department fixed assets (including oil and gas leases).
- d. Add - "Fair market values" of exploration and production department assets as determined by experts.

⁴ The total values for Shell Oil's oil and gas leases included in denominators of Shell Oil's property factor in its returns were lower, in all years except 1971 and 1972, than the values of the same properties reflected in the "Oil Industry Comparative Appraisals" of John S. Herold, Inc. Shell Oil's method of valuation on its tax returns also resulted in smaller valuations than those resulting from the method prescribed by the Securities and Exchange Commission.

⁵ The purchase price of oil and gas properties is typically a lump sum and is not affected by the future productivity of the property.

consideration: (1) lease bonus, (2) delay rental, and (3) royalty. Failure to pay any one of these agreed considerations results in forfeiture of the leasehold.

Lease bonus amounts are set through negotiation or sealed bid, generally at so much per acre or so much for an entire tract. The lease bonus amount varies depending upon the parties' assessment of the potential for oil and gas production. The lease bonus is generally negotiated in conjunction with the royalty.⁶ Lease bonus amounts tend to be lower in unexplored areas where production potential is so speculative that producers are unwilling to make large up-front payments. Once an oil and gas property becomes proven, the lease bonus is then but a small fraction of the property's value.

Delay rentals are periodic payments which keep a lease in effect during the period prior to production. Most of Shell Oil's leases run for a primary period of five to ten years, but require Shell Oil as the lessee to commence drilling within a specified time period, e.g., one year of execution of the lease. If drilling is not commenced within the specified time period, the lease will terminate unless Shell Oil makes delay rental payments to the lessor which are set at a specified amount, such as \$1.00 per acre.

Royalties are periodic payments based on production. As compared with bonus and delay rental payments, royalties are the largest sums paid by Shell Oil for its oil and gas leases. Traditionally, oil and gas royalties have generally been one-eighth of production, but by 1978 one-sixth royalties had become common. Most oil royalties are payable either in cash or in kind; gas royalties are generally payable in cash. As a practical matter, Shell Oil typically takes all oil and gas production and pays royalties in cash.

⁶ All other things being equal, the higher the lease bonus, the lower will be the royalty. Conversely, the lower the lease bonus, the higher will be the royalty.

7. The three sample oil and gas leases attached to the stipulation of facts herein have substantially similar provisions regarding the payment of royalties. The language of the first sample lease attached to such stipulation is as follows:

"3. The lessee shall deliver to the credit of the lessor as royalty, free of cost, in the pipe line to which lessee may connect its wells the equal of one-eighth part of all oil produced and saved from the leased premises, or at the lessee's option, may pay to the lessor for such one-eighth royalty the market price for oil of like grade and gravity prevailing on the day such oil is run into the pipe line, or into storage tanks.

4. Lessee shall pay lessor, as royalty, for gas, including casinghead gas, produced from leased premises and sold by lessee, one-eighth of the net amount realized by lessee, computed at the mouth of the well. If such gas is not sold but is used by lessee off leased premises or in the manufacture of gasoline or other products, then lessee shall pay lessor, as royalty, one-eighth of the market value of said gas as such at the mouth of the well."

8. The lease bonus⁷ and delay rentals⁸ are included in calculating the denominators of the property fractions in all three valuation methods. Neither the net book value method nor the fair market value method of calculation described in Finding of Fact "5", supra, recognizes royalties in computing the denominator of the property fraction. The alternative method proposed by Shell Oil, the capitalization of royalties as rents method, recognizes royalties in computing such denominator.

⁷ Shell Oil capitalizes the lease bonus amounts which are then amortized over a period of years. The amortization period begins on the date of lease acquisition and is based on Shell Oil's experience with respect to the period for which it has held other oil and gas leases prior to abandonment. The unamortized lease bonus amount for a productive lease is amortized in proportion to annual production. For an unproductive lease, the unamortized lease bonus amount is written off in the year of abandonment.

⁸ Delay rentals are included in petitioner's capitalization of its rentals.

9. On the average, only one of every nine oil and gas wells drilled in unproved areas of the United States results in the discovery of oil or gas. Only one well in every forty or fifty yields oil or gas in commercial quantities. Once a well is productive, Shell Oil establishes a value determined partially by an estimate of proved reserves.⁹ The existence and size and physical characteristics of the oil and gas can be measured through various instruments and equipment that have been developed as part of the oil and gas industry.¹⁰

10. The Audit Division and Shell Oil agreed upon the following comparison of values for Shell Oil's oil and gas leases based upon the utilization of each of the three valuation methods noted in Finding of Fact "5", supra:

<u>YEAR</u>	<u>NET BOOK VALUE METHOD</u>	<u>FAIR MARKET VALUE METHOD</u> ¹¹	<u>CAPITALIZATION OF ROYALTIES AS RENTS METHOD</u> ¹²
1971	\$295,378,187	\$2,658,216,223	\$1,569,085,787
1972	\$329,063,467	\$2,629,958,852	\$1,583,061,051
1973	\$365,237,722	\$2,765,652,389	\$1,628,562,186
1974	\$456,093,047	\$3,445,543,793	\$2,556,897,983
1975	\$612,177,056	\$3,860,074,252	\$2,876,146,368
1976	\$714,941,318	\$3,664,361,504	\$3,089,074,134
1977	\$801,980,571	\$3,997,942,326	\$3,324,932,691

⁹ Reserves of oil and gas are the estimated volume of oil and gas that will be produced over the entire remaining productive life of the properties based on existing technology and according to the facilities that are available to carry out the production.

¹⁰ At the hearing herein, petitioner's senior staff engineer in the exploration and production economics department described three methods for measuring reserves: (1) by measuring the electrical properties of the underground rock; (2) drill system tests which measure the physical and chemical properties of fluid samples obtained from the reserves, and (3) by running laboratory tests on underground rock obtained by a coring operation.

¹¹ Entries under this heading are the amounts on Shell Oil's books for the oil and gas leases plus the values in excess of book values attributable to the fair market value determined by Shell Oil's experts.

¹² Entries under this heading are the amounts on Shell Oil's books for the oil and gas leases plus the exploration and production royalties treated as rentals multiplied by eight. The amounts of royalties utilized by Shell Oil in applying this valuation method were retrieved by Shell Oil from its books and records, and the Audit Division conceded their accuracy.

11. Shell Oil does not disagree with the Audit Division's use of the net book value method to value assets on its balance sheets (other than its oil and gas leases) since Shell Oil concedes that the net book valuation of such assets are roughly approximate to their fair market valuation and can be easily reported and audited.

12. Shell Oil argues in its brief that if the Audit Division is allowed to ignore the fair market value requirement of Tax Law §210.3(a)(1), then it is entitled to relief under (i) Tax Law §210.8 which gives the State Tax Commission the discretion to adjust a corporation's business allocation percentage to properly reflect the business of a taxpayer within New York, and (ii) the commerce and due process clauses of the United States Constitution.

13. Included in petitioner's brief are proposed findings of fact which have been incorporated into this decision except for (i) proposed findings of fact "3", "4", "5", the first three sentences of "6", "7", "8", "14", "19", "20", "22", "23", "24", "25", "26", "27", "29", "31", "35", "36", "37", "38", "39", "40" and "41" which are deemed unnecessary for purposes of this decision, and (ii) proposed findings of fact "48", "49" and "50", designated by petitioner as "ultimate findings of fact", but which are more in the nature of "conclusions of law".

CONCLUSIONS OF LAW

A. That pursuant to Tax Law §210.1, the corporate franchise tax is calculated on one of four alternative bases, the first (which is at issue herein) being the portion of the taxpayer's entire net income allocated to New York which is ascertained by multiplying business income by a business allocation percentage, and investment income by an investment allocation percentage, and adding the two products.

B. That pursuant to Tax Law §210.3, the business allocation percentage is derived by means of a three-factor formula using the ratio of property, receipts and payroll within and without New York. The property factor is determined by:

"(A)scertaining the percentage which the average value of the taxpayer's real and tangible personal property within the state during the period covered by its report bears to the average value of all the taxpayer's real and tangible personal property wherever situated during such period...". Tax Law §210.3(a)(1).

The parties herein disagree concerning the proper method for valuing petitioner's oil and gas leases for purposes of calculating such factor.

C. That §4.13(a) of the Ruling of the State Tax Commission, March 14, 1962, which was effective for all of the years at issue except 1976 and 1977, provides as follows:

"The percentage of the taxpayer's real and tangible personal property within New York is determined by dividing the average fair market value of such property within New York (without deduction of any encumbrances) by the average fair market value of all such property within and without New York. Such property should be included only for the period covered by the report. In determining such percentage real property rented to the taxpayer as well as real and tangible property owned by it must be considered".

This provision was restated in 20 NYCRR 4-3.1(a) which was effective for 1976 and 1977.

D. That petitioner's oil and gas leases have an ascertainable fair market value. Cf. Fleming v. Commissioner, 153 F.2d 361, 363, 364 (5th Cir. 1946) and Massey v. Commissioner, 143 F.2d 429 (5th Cir. 1944). Furthermore, the parties agreed on fair market values¹³ for the oil and gas leases (if the fair market

¹³ The fair market values were determined by petitioner's experts by the use of a discounted cash flow method which is described in detail in Finding of Fact "5", supra. It is noted that such method is currently used to value oil and gas rights for purposes of the real property tax law. Real Property Tax Law §592.1.

value method was held to be applicable herein) as noted in Finding of Fact "10",
supra.

E. That pursuant to the ruling and regulations cited, supra, the fair market value method is the proper method to value petitioner's oil and gas leases for purposes of determining the property factor of petitioner's business allocation percentage.

F. That the petition of Shell Oil Company is granted.

Dated: Albany, New York

STATE TAX COMMISSION

OCT 05 1984

Richard A. Allen
PRESIDENT

Francis R. Koehn
COMMISSIONER

Mark J. [Signature]
COMMISSIONER